

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 01-0294 AGI  
ADJUSTED GROSS INCOME TAX  
FOR TAX PERIODS: 2000**

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**Issues**

**1. Adjusted Gross Income Tax: Claim of Right Doctrine**

**Authority:** 26 USCA 1341.

The taxpayer protests the denial of a credit claimed based upon the Claim of Right Doctrine.

**2. Adjusted Gross Income Tax: Doctrine of Equitable Recoupment**

**Authority:** 26 USCA 1341, IC 6-8.1-9-1, U.S. v. Dalm, 110 S.Ct. 1361 (1990), Indiana Department of Revenue v. Smith, 473 N.E.2d 611 (Ind. 1985),

The taxpayer requests a refund of taxes paid pursuant to the Doctrine of Equitable Recoupment.

**Statement of Facts**

The taxpayers are a married couple filing a joint Indiana Adjusted Gross Income Tax Return. The husband sold a business in October of 1996. A portion of the sales price was paid at closing with the remaining purchase price paid in annual installments on the first and second anniversaries of the closing. As a part of the agreement, the taxpayer agreed to indemnify the buyer for all claims made against the buyer for which notice was given to the taxpayer prior to the sixth anniversary of the closing date. Such indemnifications were to be an adjustment of the original sales price.

In 2000, the buyer exercised its right of indemnification in regards to a lawsuit filed against the buyer by a former customer of the business. The taxpayer's share of the settlement and corresponding legal fees amounted to \$239,591. This adjustment of the original sales price

caused the taxpayer to recompute the tax previously paid to the Indiana Department of Revenue (hereinafter referred to as the “department”). The taxpayers asked for a recovery of the tax previously paid under the claim of right doctrine on line 11 of schedule 2 of their 2000 IT-40. Although the \$10,410 represents a recovery of taxes paid based upon the taxpayers’ best estimate of the taxable gain generated from the installment sale, the taxpayer concluded that the “Indiana Credits” schedule appeared to provide the best solution as to how to present this recovery. The department disallowed this credit and sent the taxpayers a “Notice on Intent to Offset.” The taxpayers protested the disallowance of the credit and a hearing was held.

## **1. Adjusted Gross Income Tax: Claim of Right Doctrine**

### **Discussion**

The so-called “Claim of Right Doctrine” is really not a doctrine at all. It is a procedure created by statutory law, 26 USCA 1341, for the computation of tax where the taxpayer restores a substantial amount of income previously reported under a claim of right. If the taxpayer meets the criteria set out in this federal statute, then the taxpayer may be entitled to a deduction or a credit in a later year because it is established that the taxpayer did not have an unrestricted right to the income. This statute applies to the federal return but not the state return because Indiana has not adopted Section 1341 of the Internal Revenue Code. Also, Indiana has not enacted its own statute pertaining to the claim of right situation. Therefore, the taxpayer cannot recover his alleged overpayment of the Indiana adjusted gross income tax through the claim of right doctrine.

### **Finding**

The taxpayer’s protest is denied.

## **2. Adjusted Gross Income Tax: Doctrine of Equitable Recoupment**

### **Discussion**

Federal courts have created, and Indiana courts have recognized, the “Doctrine of Equitable Recoupment.” Because this doctrine is judicially and not statutorily created, it is governed by case law. Under this doctrine, the bar of the statute of limitations may be avoided by a taxpayer or the department in certain limited circumstances. The doctrine prevents inconsistent tax treatment of a single transaction or event with regard to a single taxpayer or different taxpayers with a significant identity of interest. It arises where the claim of one party, whether for unpaid taxes or for a refund, is open, while the related and conflicting claim of the other party is barred by the statute of limitations. Thus, for a taxpayer, the doctrine of equitable recoupment permits a time-barred refund claim to reduce a related liability that has been timely asserted by the department.

An essential element of the doctrine of equitable recoupment is that a single transaction or event be subject to two taxes on inconsistent legal theories. It is based on the concept that a transaction that is the subject of judicial attention should be examined in all its aspects, and any judgement that is rendered must do justice in view of the one transaction as a whole. As the United States Supreme Court stated in U.S. v. Dalm, 110 S.Ct. 1361 (1990), at page 1368: “. . . a party litigating a tax claim in a timely proceeding may, in that proceeding, seek recoupment of a related, and inconsistent, but now time-barred tax claim relating to the same transaction.” The Court went on to hold that the doctrine of equitable recoupment cannot be the sole basis for jurisdiction of a refund suit and stated at page 1369:

Our conclusion is reinforced by the fact that congress has legislated a set of exceptions to the limitations period prescribed by Sections 7422 and 6511(a). In 1938, Congress adopted what are known as the mitigation provisions, now codified at Section 1311-1314. These statutes, in specified circumstances, permit a taxpayer who has been required to pay inconsistent taxes to seek a refund of a tax the recovery of which is otherwise bared by Section 7422(a) and 6511(a). It is undisputed that Dalm’s action does not come within these provisions; were we to allow her to maintain a suit for refund on the basis of equitable recoupment, we would be doing little more than overriding Congress’ judgment as to when equity requires that there be an exception to the limitations bar.

Although the Court did not mention Section 1341 of the Internal Revenue Code, Computation of Tax Where Taxpayer Restores Substantial Amount Held Under Claim of Right, it would have the same effect where the taxpayer is outside the statute of limitations for amending the reporting year.

The doctrine of equitable recoupment was specifically recognized by the Indiana Supreme Court decision in Indiana Department of Revenue v. Smith, 473 N.E.2d 611 (Ind. 1985). In this case, real estate held by spouses as tenants by the entireties and then transferred by them to their children subject to joint and successive life estates in the spouses was correctly subject to inheritance tax at the time of death of the last spouse. However, at the death of the first spouse, one-half of the real estate was incorrectly taxed in the first spouse’s estate. A claim for refund of the erroneously paid inheritance tax was never filed. Instead, the second spouse’s estate attempted to include only one-half of the real estate as being taxable due to the reporting error in the first estate. The department petitioned the court for inclusion of the full value of the real estate as required by statute. The Supreme Court held that the department was correct but that under the doctrine of equitable recoupment, the estate was entitled to a credit for the taxes erroneously paid in the first estate.

Although the doctrine of equitable recoupment was developed by the courts, it may be applied under the appropriate circumstances in an administrative proceeding. Therefore, if the Department finds that recoupment would be allowed as a defense against a tax assessment in a case in which a court would have uncontested jurisdiction to adjudicate one of the taxes in question, then the department could allow the application of the doctrine without first requiring that suit be filed.

For taxpayers, the doctrine of equitable recoupment applies only to the following set of circumstances:

- (1) The department has a claim for unpaid taxes which is open.
- (2) The taxpayer has a refund claim which is barred by the statute of limitations.
- (3) The claim for unpaid taxes and the refund claim are based on a single transaction or event that has been subjected to two taxes on inconsistent legal theories.
- (4) Only a single taxpayer, or different taxpayers with a significant identity of interest, is involved.

The taxpayer's situation would have to satisfy all four of the above criteria or the doctrine of equitable recoupment would not apply. In this case, the taxpayer's situation meets three of the requirements. The department has an open claim for unpaid taxes. The taxpayer has a refund claim that is barred by the statute of limitations. Only one taxpayer is involved. There are not, however, two inconsistent legal theories for the imposition of taxes. The taxpayer reported an amount of income and the department claimed the appropriate amount of taxes on the reported income. The taxpayer did not report the amended amount of income during the statutorily prescribed period. Therefore, the taxpayer's claim is barred by the statute of limitations.

As pointed out by the United States Supreme Court in Dalm, supra, the doctrine cannot be applied to simply allow a refund claim that is otherwise barred by the statute of limitations, no matter how meritorious the claim may be. The remedy for a straight refund claim is controlled by IC 6-8.1-9-1.

### **Finding**

The taxpayer's claim for refund pursuant to the Doctrine of Equitable Recoupment is denied.